The Future of Banking Regulation

Basel III - Recipe for safer banks?

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PLAN

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1. The crisis: failure of regulatory framework

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Timeline of the crisis

- US housing bubble … liquidity shortfall ….. collapse of large financial institutions …. bail-out of banks by government …. downturn of stock markets around the world …. decline in consumer wealth … global economic crisis …. over-indebtedness of states, etc., etc.

Banking industry at the source of the crisis

- Banks lost USD 2.8 trillion form 2007 -2010
- further loss between 40% - 60% still to come?
- Numerous failures: Lehman, Northern Rock, Merrill Lynch, Fannie Mae, Freddie Mac, AIG, UBS, RBS, Anglo Irish, Washington Mutual...

Conclusion: regulatory framework failed!

2. Present state of international discussion (1)

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G20

- rather political forum
- top priority to systematically important institutions

Financial Stability Board (FSB)

- established by G20 in 2009
- members are national authorities responsible for financial stability in significant international financial centres
- coordination of international regulation and supervision

Basel Committee

- New standard Basel III was agreed upon 12 September 2010

2. Present state of international discussion (2)

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European Union

- European Systematic Risk Board
- focus on macro-supervision and systematic risks of systematically important banks
- European Banking Authority (EBA), Insurance Authority (EIOPA) and Securities and Markets Authority (ESMA)

National efforts

- US: The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010
- a few selective measures, no comprehensive reforms

3. Basel III – historic background (1)

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Basel Committee on Banking Regulation

- established in 1974
- members are the central banks and banking supervisory authorities of 27 countries.
- minimum international standards for banking regulation and supervision
- Widely implemented on national level

Basel I

- “Basel Accord” issued in 1988
- primarily focused on credit risk
- min. capital: 8% of risk-weighted assets, of which min. 4% common stock
- Risk weighting: assets of banks are classified in 5 categories carrying risk weights between zero (e.g. home country sovereign debt) to 100%

3. Basel III historic background (2)

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Basel II

- published initially in 2004, updated several times thereafter
- minimum capital requirement
    - Basel I (8% of which 4% common stock)
    - credit risk, market risk, operational risk
    - the bank's own risk measurement systems allows to potentially lower risk capital requirements
- provides principles for effective supervision
- transparency obligations

Basel II and the crisis

- lesson from the crisis: Basel II and banking supervisors have grossly underestimated the level of capital needed by banks to prevent such a crisis.

4. Basel III – the new rules (1)

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Agenda

- approved on 12 September 2010 by Basel Committee
- to be backed by G20 summit in November 2010

What is new as compared to Basel II?

- **More capital:** from 8% to 10.5%
- **Better capital quality:** from 2% common equity to 7%
- **Macroprudential overlay** for systematically important banks: still to be determined

Timetable for implementation

- gradual national implementation starting 2013
- to be fully implemented on 1 January 2019

4. Basel III – the new rules (2)

Outstanding issues

- additional rules on systematically important institutions
- countercyclical capital buffer
- net stable funding ratio (NSFR)

Basel III - only minimum standard

- national rules may set higher standards

4. Basel III – the new rules (3)

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Swiss implementation of Basel III

	Basel III	Swiss implementation
I. Minimum requirement	8 % total capital,of which at least: 4.5 % common equity 6 % tier 1	same as Basel III
II. Buffer	2.5 % common equity	8 % total capital,of which: min. 5.5 % common equity max. 3 % CoCos trigger at 7 % common equity
III. Progressive component	*surcharge for systemically important banks yet to be defined*	6 % CoCos
Total requirements	**10.5 % total capital of which min. 7 % common equity**	**19 % total capital of which min. 10 % common equity**

5. Basel III – critical review

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Positive

- increase from 2% of common equity to 7% is substantial
- expected further increase for big banks

Negative

- **transition period** is too long
- absence of new rules on **risk weighting**
- Limitation to rules on capital requirements
- minimum standard – race for advantages on national level ?

Basel III – good enough to stand firm in new crisis?

6. Concluding remarks

Very slow process for new banking regulations

- more than 2 years after Lehman collapse
- Basel III as the most important reform on an international level so far

Necessary reforms ahead of us

- clear need for more international regulations
- strong independent supervisor, international supervision?
- reformulate the objectives of bank regulation:
  - macro-prudential vision
  - Not meant to tell banks how they should manage their risks, but to identify problems and “bad sheep” before it is too late

Pernicious effect of banking regulations….

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if the banks can do what they want…..

The next crisis will come for sure!

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